FASB Derivative Accounting Standards

Testimony of

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Derivatives Controversy

- Warren Buffett: “Derivatives are financial weapons of mass destruction. … The dangers are now latent – but they could be lethal.”

- Alan Greenspan: “[Derivatives] have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago.”

- Randall Dodd (Director, Derivatives Study Center): “It’s a double-edged sword. … Derivatives are extremely useful for risk management, but they also create a host of risks that expose the entire economy to potential financial market disruptions.”

Source: Washington Post, 3/6/03

Increasing Importance and Role for Derivatives

- The use of derivatives has grown exponentially in recent years
  - The total value of derivatives outstanding is estimated to be $127 trillion – up from $3 trillion in 1990
- Demand for risk management was created in mid-1970's as market risk (i.e., interest rate risk, foreign currency price risk, and commodity price risk) exploded due to
  - U.S. breaking of Brenton Woods Accord, which had pegged currency exchange rates to the U.S. dollar
  - Oil price volatility post-OPEC control in 1970s
- For companies to be economically successful, they now need to manage both operating and market risks

Managing Market Risks with Derivatives

- Low cost, ease, and speed of transacting make derivatives attractive for managing market risk
- Different derivatives provide means of adjusting the timing, amount, and variability of cash flows/ fair values
- Derivatives are ideal for both hedging and speculation
  - For Fannie Mae and Freddie Mac, derivatives primarily used to manage interest rate risk in debt
- Key perspective: Derivatives do not eliminate risk; derivatives shift or change risks faced by a firm

Accounting Model Prior to Late 1990s

- Derivatives and derivatives risks not transparent in financial reports
- Accounting model was incomplete and inconsistent
  - Hedge accounting available for some derivatives and not others
  - Criteria for hedge accounting differed by type of derivative
- Firms found ways to justify hedge accounting even when qualifying criteria not met
- In general, financial reporting was poor, allowing firms to manipulate income!

New Accounting Model

The SEC and FASB addressed these problems by issuing new accounting rules requiring

- Disclosures about market risk in 10-K filings in a section similar to M,D&A
  - SEC Financial Reporting Release No. 48 (1997)

- A new model to account for derivatives and hedging activities in financial statements and related footnotes
  - FASB Statements of Financial Accounting Standards (FAS) Nos. 133, 138 and 149 plus implementation guidance

Effects of New Accounting Model - I

- Model makes derivatives and derivatives risks more transparent in financial statements
- Model is complete and generally consistent
  - Provides uniform framework for determining the financial reporting for all derivatives and hedging activities
- Model is extremely complex, making it difficult to implement
- Model allows hedge accounting only when specific rigorous qualifying criteria are met
  - Requires extensive systems development and supporting documentation
  - Diminishes ability to manipulate income
- Model generally reports hedge ineffectiveness in current period income

Effects of New Accounting Model - II

Model is changing how firms manage risks

- Using simple more basic derivatives, which are more effective in offsetting designated risk
- Coordinating risk management program across risk exposure categories
  - Improving measurement and management of risks
  - Diminishes need and use for derivatives

Effects of New Accounting Model - III

- Model generally does not capture the complete economic effects of a firm's net market risk exposure in current period income because it
  - Promotes risk management at the transaction not entity level
  - Promotes derivatives as the only hedging instrument, generally not allowing hedge accounting for firms managing risks with non-derivatives
  - Allows deferral from current income recognition of unrealized gains and losses on derivatives used in cash flow hedges

A Look to the Future

- The way to fix the problems described on the prior slide is to issue a standard that
  - Requires full fair value accounting for all financial instruments in the balance sheet and income statement
  - Eliminates fair value and cash flow hedge accounting
- FASB foreshadowed the need for such a standard in FAS 133 and currently is considering issuing such a standard
- This standard was not issued previously due to
  - Timely need to issue a standard making the effects of derivatives more transparent in financial reports
  - Extreme political pressures by constituencies
    - Against fair value accounting for financial instruments
    - For specific forms of hedge accounting that minimized the income statement effects of hedging transactions
  - Need to develop guidance on how to measure fair value

Evaluation - I

Is the complexity of FASB's derivatives standards to blame for Freddie Mac's problems?

- I believe not!
- Freddie's accounting problems were not limited to FASB's derivatives standards
  - Freddie misapplied four different sets of accounting standards to achieve its earning targets, two of which are not complex
- Fannie Mae prepares its reports in compliance with generally accepted accounting principles (GAAP)
- Fannie's reports provide useful and understand-able information about its interest rate risk exposures
  - Complex accounting standards do not necessarily lead to confusing financial reports

Evaluation - II

Would setting principles- versus rules-based standards necessarily minimize financial statement issuers problems, leading to better information for Freddie's and Fannie's investors?

- Not likely
- Freddie violated both principles- and rules-based standards in achieving its earnings targets
- For principles-based standards to work, people need to apply the standards in investors' bests interests promoting transparency
- Rules-based standards have one advantage; they set bounds that monitors can evaluate more easily

Recommendations - I

How can Freddie's and Fannie's investors be better served?

- Require the companies to prepare periodic financial reports in conformity with GAAP
  - Do not allow such compliance to be voluntary
  - Should make monitoring by Boards of Directors and auditors more effectual
  - Will make information more comparable to other financial institutions exposed to interest rate risk
- Require their regulator to include in core capital unrealized derivatives' gains and losses on cash flow hedges
  - Currently these gains and losses resulting from ***current*** interest rate movements are excluded from income and core capital for periods up to ***30 years***

Recommendations - II

How can Freddie's and Fannie's investors be better served?

- Issuance of a FASB standard requiring the fair valuing of all financial instruments
  - Will require Congressional nonintervention to help insulate the FASB from political pressures from its constituents
  - Information reported under this standard will allow investors to best understand Freddie's and Fannie's exposure to current interest rate changes!
  - Will make financial statements of firms hedging with non-derivatives comparable to those hedging with derivatives